

***United States Court of Appeals
for the Second Circuit***



**RESPONDENT'S
BRIEF**

76-4078

Signed

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IRVING MALAWER and RUTH MALAWER,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

ON APPEAL FROM THE DECISION
OF THE TAX COURT

BRIEF FOR THE APPELLEE

B
P/S

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
FRANCIS J. GOULD,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

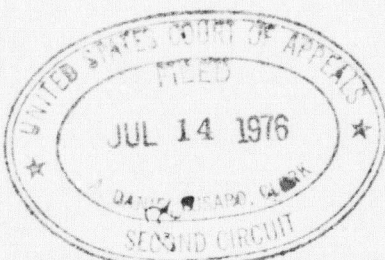


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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court properly held that taxpayer had failed to show that any of the stock he held in Realty Transfer Corporation constituted Section 1244 stock and that, accordingly, taxpayer was not entitled to deduct any of the losses he sustained when that stock became worthless as ordinary losses under the provisions of Section 1244 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE

This action was commenced by taxpayer^{1/} for a redetermination of the income taxes for the year 1964, involving an asserted deficiency of \$16, 192.37. (Statutory Notice of Deficiency.) The memorandum findings of fact and opinion of the Tax Court (Judge Quealy) was filed on December 8, 1975, and is reported at P-H Memo T.C., par. 75,351. A decision, determining a deficiency in income taxes of \$16,192.37, was entered on December 9, 1975. Taxpayer timely filed a notice of appeal on March 8, 1976. Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The relevant facts, as found by the Tax Court and otherwise reflected by the record, may be summarized as follows:

In his individual income tax return for the taxable year 1964, filed on October 15, 1965, taxpayer claimed to have incurred a loss of \$112,321.91 when the stock he owned in Realty Transfer Corporation became worthless. He claimed that all of that stock had been issued to him pursuant to a plan conforming to Section 1244 of the Internal Revenue Code. In accordance with the limitations set forth in Section 1244(b), taxpayer claimed an ordinary loss deduction of \$50,000 and a capital loss deduction of \$62,321.91 on the joint return he and his wife filed. On March 17, 1966, taxpayer filed an amended 1964

^{1/} Irving Malawer is designed taxpayer herein. Ruth Malawer, Irving's wife, is a formal party to this suit because she and her husband filed a joint tax return.

return. In this return, he reduced the amount of his claimed loss from \$112,321.91 to \$84,587.07, but he still claimed a \$50,000 ordinary loss deduction under Section 1244 of the Code. (Exs. 1-A, 2-B.)

The Commissioner of Internal Revenue disallowed the claimed ordinary loss deduction of \$50,000. He permitted taxpayer, however, to treat the entire loss with respect to Realty Transfer as a long-term capital loss. (Statutory notice of deficiency.) Thereafter, taxpayer instituted proceedings in the Tax Court. (Petition.)

Realty Transfer Corporation (hereinafter referred to as Realty Transfer), was incorporated in Florida on August 7, 1957, for the purpose of constructing and operating rental housing units. (Appendix B-3.) On November 16, 1959, Realty Transfer purchased real property in Winter Park, Florida. While taxpayer presented certain evidence that during the period from November 16, 1959, through June 4, 1962, the property was surveyed and cleaned up, a building on the property was demolished, architectural plans were drawn and submitted, projections of anticipated income and expenses were prepared, funding for the project was secured, and brochures advertising the building for rental were prepared, the Tax Court entered no affirmative finding as to those matters. The Tax Court did find that no bank account had been opened for the corporation until 1962. No corporation income tax returns were filed for the years 1957 through 1961, inclusive. On October 15, 1965, the income tax

returns covering the years 1962 through 1964, inclusive, were filed on behalf of the corporation. (R. 5-17^{2/}.) On June 30, 1967, the corporation was dissolved for failure to pay its corporation capital stock tax. (Ex. 8-H.)

Taxpayer presented in evidence a single sheet of paper purporting to be a copy of the minutes of the first meeting of the board of directors, although he testified that the board had indeed convened on numerous occasions prior to June 4, 1962. (Tr. 54-55.) The copy of the purported minutes of June 4, 1962, listed the stockholders George Melter, Jack Malawer, Irving Malawer and Irving Weider, all of whom were stated to be present. According to the minutes, a plan had been adopted whereby 50 shares of stock, each having a par value of \$5, would be issued over a period of not more than two years pursuant to Section 1244 of the Code for an aggregate amount not to exceed \$500,000. Certificates were to be issued, for the consideration shown, as follows (R. 18):

<u>Stockholders</u>	<u>Number of Shares</u>	<u>Amount</u>
Jack Malawer	9-5/8	\$ 27,782.97
Irving Malawer	9-5/8	27,782.96
George Melter	11-1/2	24,056.57
Irving Weider	19-1/4	89,544.86
Totals	<u>50</u>	<u>\$169,167.36</u>

2/ "R." references are to the separately bound "Appendix and Exhibits". Taxpayer filed this Appendix without having designated the materials he intended to include therein or having given the Commissioner an opportunity to counter-designated materials for inclusion in that Appendix. For the convenience of this court, we have reproduced the opinion of the Tax Court in our Appendix B.

No evidence was submitted with respect to the issuance of the stock certificates referred to in the plan, although Realty Transfers stock book was in taxpayer's possession. His counsel stated that no stock was issued until June 15, 1964. (Tr. 4.)

Taxpayer's accountant, Frank E. Knopf, testified that taxpayer and his brother, Jack Malawer, conducted their affairs as a partnership, including the investment in Realty Transfer. He stated that accounts of both taxpayer and Jack Malawer were kept in the name of Jack Malawer as part of a private business arrangement between them. Knopf kept ledger sheets of monies disbursed by Jack and Irving Malawer for investment in Realty Transfer. None of the entries indicate the money was disbursed for Section 1244 stock.

On October 15, 1965, corporation income tax returns were filed on behalf of Realty Transfer for the calendar years 1962, 1963, and 1964, using the cash basis method of accounting. In amended returns filed February 14, 1966, Realty Transfer reported losses as follows:

<u>Year</u>	<u>Loss</u>
1962	\$ -0-
1963	7,879.05
1964	425,118.92

The 1962 return reported that \$169,167.36 in capital stock was outstanding at the end of the year, although, according to the recital on the return, no stock had been outstanding at the beginning of the year. The corporation had abandoned its Florida property by 1964, and the 1964 return showed that the corporation owned no assets as of the end of the taxable year.

At trial, taxpayer conceded that not more than \$27,782.96 of his claimed loss of \$50,000 was attributable to Section 1244 stock. Taxpayer contended that the copy of the purported minutes established the adoption of a plan for the issuance of Section 1244 stock. He further asserted that the corporation's income tax return for 1962 supported his argument that the stock had been issued pursuant to the alleged Section 1244 plan because the capital stock outstanding at the end of the year exceeded the stock outstanding at the beginning of the taxable year 1962 by the exact amount stated in the purported plan.

The Commissioner of Internal Revenue challenged both the authenticity of the minutes and the adequacy of the evidence presented by taxpayer with regard to the issuance of stock which would qualify under Section 1244.

The Tax Court upheld the determination of the Commissioner. It concluded that taxpayer had failed to present sufficient evidence to meet his burden of proving that Realty Transfer adopted a plan to issue Section 1244 stock, in accordance with Section 1244(c)(1)(A), or that Realty Transfer had issued stock pursuant to such a plan, as required by Section 1244(c)(1)(D). (Opinion, Appendix B, infra, pp. 1-16.)

From the decision entered in accordance with that opinion, taxpayer appeals.

SUMMARY OF ARGUMENT

Section 1244 was added to the Internal Revenue Code in 1958 to encourage the financing of "small business corporations," by according ordinary, rather than capital, loss treatment to qualifying stock investments in such corporations if the venture turned out to be financially unsuccessful. However, before they can claim the special benefits of that Section, stockholders must satisfy the express conditions precedent set forth in the statute and the implementing Treasury Regulations. One of these conditions precedent is that the corporation must have adopted a written plan to offer such stock during a specified period ending within two years from the date of the adoption of the plan and another is that the stock must be issued during such period pursuant to the plan. Section 1244(c)(1)(A) and (D).

The Tax Court concluded that taxpayer had not presented sufficient evidence to meet his burden of proving that Realty Transfer Corporation had adopted a plan to issue Section 1244 stock, in accordance with Section 1244(c)(1)(A), or that Realty Transfer Corporation issued stock pursuant to such plan, as required by Section 1244(c)(1)(D). Accordingly, it held that none of the losses sustained by taxpayer as a result of his investment in that corporation could qualify for the preferential treatment accorded losses on Section 1244 stock.

The Tax Court's determinations below were clearly correct. The only proof taxpayer introduced to show that Realty Transfer had adopted a plan to issue Section 1244 stock was a purported

copy of the minutes of a meeting purportedly held by the corporation's board of directors. While these purported minutes reflected that the corporation intended to issue Section 1244 stock, there was, as the Tax Court noted, substantial room to doubt that they were authentic. Certain factual recitals contained in these purported minutes were, as taxpayer admitted, totally inaccurate. And taxpayer's inability to produce the corporate minutes book, any witness to corroborate that the meeting actually took place, or, indeed, copies of the minutes of any board meeting except the one crucial to his present claim to an ordinary loss deduction, speaks volumes as to the authenticity of those minutes. The Tax Court had ample warrant for holding that these minutes alone could not establish that Realty Transfer had a plan to issue Section 1244 stock.

Nor was taxpayer able to show that any stock was ever issued to him pursuant to any plan. Even though both he and the corporation were required under the Regulations to maintain records sufficient to identify any stock issued under a Section 1244 plan and even though taxpayer admittedly had the corporation's stock transfer book in his possession, he introduced no evidence to show that any stock had been issued pursuant to the plan purportedly agreed upon at the board of directors meeting.

Taxpayer's proof, as the Tax Court found, fell far short of that required to show that stock was issued and investments were made with the prospective benefits of Section 1244 in view. The Tax Court, for this and for other reasons, was correct in denying taxpayer the ordinary loss deduction he sought. Its decision should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY HELD THAT TAXPAYER HAD FAILED TO MEET HIS BURDEN OF SHOWING THAT ANY OF THE STOCK HE HELD IN REALTY TRANSFER CORPORATION MET THE PRECONDITIONS OF SECTION 1244 OF THE INTERNAL REVENUE CODE OF 1954 AND THAT, THEREFORE, TAXPAYER WAS NOT ENTITLED TO TREAT HIS LOSSES ON THAT STOCK AS ORDINARY LOSSES AS PROVIDED BY SECTION 1244

A. Introduction

Generally, a loss incurred in the sale or exchange of capital stock or when that stock becomes worthless (see, Internal Revenue Code of 1954, Section 165(g), Appendix A, infra) is a capital loss, deductible only against certain limited classes of income. Internal Revenue Code of 1954, Sections 1211 and 1212. On the other hand, a similar loss incurred with "Section 1244 stock" will, within limitations,^{3/} give rise to an ordinary loss, deductible against gross income, with carryovers or carrybacks to other taxable years as ordinary losses. Internal Revenue Code of 1954, Sections 172 and 1244, Appendix A, infra.

Section 1244 was designed to encourage investment in small business corporations by granting investments that met the qualifications set forth in the statute special tax benefits--

^{3/} Section 1244(b) imposes an annual limitation of \$25,000--\$50,000, if a joint return is filed--on the amount of ordinary loss a taxpayer may deduct under Section 1244. Any loss for the taxable year in excess of the annual limitation is treated as a capital loss. If the loss on "Section 1244 stock" is sustained by a partnership, the limitation is determined separately as to each partner by reference to the type of return filed by that partner for the year in which the partnership's taxable year ends. Section 1.1244(b)-1, Treasury Regulations on Income Tax (1954 Code).

ordinary loss treatment to those "investments in small business which do not prove to be successful." H. Rep. No. 2198, 85th Cong., 1st Sess., p. 2 (1959-2 Cum. Bull. 709, 710). As this Court has recognized, in order to effectuate the Congressional intention to limit the benefits of Section 1244 to those investments which might have actually been induced by its incentives, a taxpayer seeking to enjoy the fruits of Section 1244 bears a twofold burden, to show that what was done met the preconditions set forth in the statute and to show that what was done was done with Section 1244 in view. Thus, this Court stated in Godart v. Commissioner, 425 F. 2d 633, 637-638 (C.A. 2, 1970):

While one could not sustain the position that Congress meant the benefits of §1244 to be given only to taxpayers who would not have invested without the promise of them, it is hard to see how its purpose would be served by according its benefits in cases where there is no indication that at the time the alleged plan was adopted the corporation had any awareness of the section or any intent to make its extraordinary tax advantages available to investors in the corporation.

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It is true enough that tax consequences generally depend on what people do and not on what they say. But Congress, if it chooses, may condition tax incentives both on doing certain things and on showing in an objective way that they were done with an intention of realizing the benefits Congress had afforded. We do not mean either that ritualistic reference to § 1244 is essential or that such a reference will save a plan that does not meet the statutory tests. We do mean that there must be some substantially contemporary objective evidence that the plan was adopted with § 1244 in view.

See H. Rep. No. 2198, supra; Anderson v. United States, 436 F. 2d 356 (C.A. 10, 1971); Childs v. Commissioner, 408 F. 2d 531

(C.A. 3, 1969); Eger v. Commissioner, 393 F. 2d 243 (C.A. 2, 1968); see Rickey v. Commissioner, 54 T.C. 680 (1970), aff'd, 502 F. 2d 748 (C.A. 9, 1974); Spiegel v. Commissioner, 49 T.C. 527 (1968).

Taxpayer here failed to show either that the stock in Realty Transfer was issued in a fashion that complied with Section 1244 or that the stock was issued with Section 1244 in view. The technical requirements for Section 1244 stock are set forth in Section 1244(c). The first requirement is that a corporation adopt a "plan" to issue common stock within a specific period of time, but in no event for a period ending later than two years after the adoption of the plan. Sec. 1244(c)(1)(A); see, e.g., Childs v. Commissioner, supra. The plan must be in writing, stating the dollar amount of stock to be issued within the stipulated period. H. Rep. No. 2198, supra. See Hayden v. Commissioner, 52 T.C. 1112 (1969); Spiegel v. Commissioner, supra. At the time the plan was adopted, the corporation must be a "small business corporation (Sec. 1244(c)(1)(B), as defined in Section 1244(c)(2)), and it must not have any prior stock offerings outstanding at the time the plan is adopted (Sec. 1244(c)(1)(C)). The common stock must be issued pursuant to this written plan.^{4/} An issuance for this purpose entails an increase in the number of outstanding shares of stock. Consequently, a contribution to capital not accompanied by the

^{4/} Stock issued pursuant to an informal plan, which was not reduced to writing until after the date of issuance, cannot qualify. Morgan v. Commissioner, 46 T.C. 878 (1966).

issuance of additional shares of stock, even though it operates to increase a taxpayer's basis in previously owned shares will not qualify under Section 1244. Section 1.1244(c)-1(c)(1), Treasury Regulations on Income Tax (1954 Code). See H. Rep. No. 2198, supra, p. 8. See also Oppenheim v. Commissioner, P-H Memo, par. 73,012. The consideration paid for the stock must consist of money or other property, not including stock or securities. Sec. 1244(c)(1)(D). Thus, a taxpayer may not convert a nonqualifying investment into a qualifying investment simply by exchanging his interest for newly issued stock of the same corporation. See, e.g., Morgan v. Commissioner, supra.^{5/}

Finally, the statute (Sec. 1244(c)(1)(E)) and the Regulations (Sec. 1.1244(c)-1(g)(2)) provide that the issuing corporation be "largely an operating company." A company must derive at least half of its gross receipts from non-passive sources, that is, from sources other than "royalties, rents, dividends, interest, annuities or sales or exchanges of stock" or it must be devoted to activities that ordinarily would result in gross receipts other than royalties, rents, dividends or interest in order to satisfy that condition. Bates v. United States, 36 A.F.T.R. 2d 6074 (D.C. Ohio), vac'd, 37 A.F.T.R. 2d 1090 (1976).

^{5/}By the same token, common stock, even though it may satisfy the literal conditions of Section 1244, may be nonqualifying if there was no business purpose for the purchase. For example, a creditor of a failing corporation exchanges his investment for stock issued pursuant to a qualifying plan in an attempt to effect an ordinary loss bail-out deduction. Bruce v. United States, 289 F. Supp. 686 (S.D. Tex., 1967), aff'd, 409 F. 2d 1317 (C.A. 5, 1969).

Under Section 1244(e), the Commissioner was given authority to issue such regulations "as may be necessary to carry out the purposes of this section." Regulations, duly issued under this authority, provide, in turn, that stock issued pursuant to Section 1244 will not qualify for the benefits of that statute unless both the issuing corporation and the shareholder-taxpayer adhere to certain record keeping requirements. The corporation is required to maintain records showing, inter alia, the person to whom the stock was issued pursuant to the plan, the date of issuance, and the amount and type of consideration received from each person.^{6/} Section 1.1244(e)-1(a), Treasury Regulations on Income Tax (1954 Code). The shareholder is required to maintain records sufficient to distinguish his "Section 1244 stock" from any other equity interest he may own in the corporation. Section 1.1244(e)-1(b), Treasury Regulations on Income Tax (1954 Code).^{7/}

^{6/} The corporation is also required to maintain records indicating the shareholder's basis in property exchanged for stock and the fair market value of that property at the time of the exchange; the identity of the certificates that represent stock issued pursuant to the plan; the amounts of money and corporate basis for other property received after June 30, 1958, and before the adoption of the plan for its stock, as contribution to capital or as paid in capital; and the equity capital of the corporation on the date of the adoption of the plan.

^{7/} The Regulations clearly condition the allowance of a deduction under Section 1244 on the maintenance of adequate records. While, of course, taxpayer argues that Realty Transfer issued only Section 1244 stock and that both the corporation's and taxpayer's records were sufficient to satisfy the Regulations, that argument can hardly be credited. Quite apart from the fact that there is no way on the basis of the records introduced below to substantiate taxpayer's claim that no other stock was issued, the corporation's records do not indicate when or with what types of property the shareholders paid for the alleged Section 1244 stock

It is our position that taxpayer here failed to establish that Realty Transfer adopted a "plan", as required by Section 1244(c)(1)(A), and that he failed to show that any stock was issued pursuant to such plan, as required by Section 1244(c)(1)(D). Rather, the circumstances plainly indicate Section 1244 was an afterthought. While, as the Tax Court held, taxpayer's failure to show that there was a "plan" or that the stock here had been issued pursuant to such a plan required entry of a decision against him, other deficiencies in taxpayer's proof below would require denying him the ordinary loss deduction he here seeks. Taxpayer failed to show that the stock here was issued by Realty Transfer to taxpayer in exchange for money or property, rather than for stock, as required by Section 1.1244(c)(1)(D) and both taxpayer and the corporation clearly failed to maintain the records required by the Regulations.

- B. Taxpayer failed to show that Realty Transfer adopted a plan to issue "Section 1244 stock" as required by Section 1244(c)(1)(A), or that Realty Transfer issued stock pursuant to such plan, as required by Section 1244(c)(1)(D)

Although taxpayer maintains that he sustained a loss on Section 1244 stock in 1964 when his investments in Realty Transfer became worthless, the record is devoid of any evidence in-

7/ (continued)

nor do they contain any of the financial data required by the Regulations, Sec. 1.1244(e)-1(a). Taxpayer's records as to the stock here are simply non-existent. The only records introduced below merely detail a series of cash disbursements that occurred over a four to five year period. They make no mention whatsoever of stock.

dicating that taxpayer was ever issued^{8/} any capital stock of Realty Transfer, much less that he was issued stock in that corporation pursuant to a Section 1244 "plan." The only evidence indicating that Realty Transfer might have adopted a plan to issue Section 1244 stock, in accordance with Section 1244(c)(1)(A), is found in a purported copy of the minutes of a meeting of Realty Transfer's board of directors purportedly held on June 4, 1962. Taxpayer did not produce the minute book of Realty Transfer in order to substantiate the authenticity of these minutes. And, indeed, certain recitals in the purported minutes gave reason to doubt that the copy introduced by taxpayer was authentic. Taxpayer admitted that the board of directors had convened on numerous occasions prior to June 4, 1962. The minutes, however, recite that the meeting of June 4, 1962, was the first meeting of the board of directors. (Tr. 54-55.) Moreover, it strains credulity to believe that of all the minutes that must have been taken at the many meetings of Realty Transfer's board (Tr. 54-55), taxpayer could find the minutes of only one meeting for introduction at trial and that one meeting, conveniently enough, was the critical one as to his present tax claim. Clearly,

^{8/} The benefits of Section 1244 are limited to losses sustained by the original investor, i.e., the individual who acquired his stock upon its issuance from the corporation in return for cash or property, and not a subsequent purchaser of the stock. Section 1.1244-1(b), Treasury Regulations on Income Tax (1954 Code).

As the Tax Court's findings indicate, taxpayer's accountant testified that the only funds forwarded to Realty Transfer were funds from a partnership owned by taxpayer and his brother. It would thus appear that taxpayer was not the original owner of any stock that might have been issued by Realty Transfer and could be denied the benefits of Section 1244 on that ground.

the Tax Court was justified in demanding more proof as to a Section 1244 plan that the purported minutes taxpayer introduced. Nor was taxpayer able to produce any evidence which corroborated that Realty Transfer had a plan for issuing Section 1244 stock or that it had issued such stock. Both below and on appeal (Br. 4), taxpayer has pointed to the fact that Realty Transfer's income tax return for the year 1962 indicated that it had \$169,167.36 in capital stock outstanding and that this amount of stock corresponds to the amounts of stock discussed in the purported minutes. But, disregarding for the moment the fact that this 1962 corporate return was not filed until October 15, 1965, the same day that taxpayer filed his 1964 return claiming an ordinary loss deduction for his stockholdings in Realty Transfer and disregarding for the moment the fact that taxpayer's accountant prepared that return for Realty Transfer, that one entry provides no corroboration for taxpayer's claim that the stock outstanding had been issued pursuant to a Section 1244 plan. Given the timing of this return and the manner in which it was prepared, it is questionable that it even provides any corroboration to taxpayer's argument that Realty Transfer had any stock outstanding. Indeed, taxpayer's counsel stated that stock was issued until June of 1964. (Tr. 4.)

8/ (continued)

Of course, taxpayer could argue that the loss he claims here is only his distributive share of the partnership's loss. However, taxpayer has introduced no evidence with respect to the income or losses incurred by such a partnership.

Clearly, none of the bookkeeping records introduced by taxpayer substantiated his claims that Realty Transfer had a Section 1244 plan and that it issued stock to him pursuant to that plan. These records merely indicate that, from 1959 on, taxpayer and his brother had been forwarding money to the Realty Transfer project. There is no dispute as to that. But these records are totally devoid of any mention of Section 1244 stock.^{9/}

Moreover, taxpayer admitted that he had corporate records in his possession directly bearing upon the question whether Section 1244 shares were issued, but he refused to introduce those records into evidence. Taxpayer admitted that he had Realty Transfer's stock transfer book in his possession. That stock transfer book, in turn, should have reflected whether any stock had been issued to taxpayer pursuant to a Section 1244 plan. Indeed, the Regulations duly promulgated under Section 1244 (Treasury Regulations on Income Tax (1954 Code), § 1.1244(e)-1(e)) require that the corporation maintain records with respect to stock issued under that Section showing, inter alia, which shares were issued pursuant to a Section 1244 plan, to whom those shares were issued and the date upon which the shares were issued. Taxpayer's failure to introduce the stock transfer

^{9/} It is interesting to note, however, that taxpayer had forwarded substantial sums to the Realty Transfer venture prior to the time of the alleged Section 1244 plan. (R. 1-4.) It is open to question whether any stock issued under a Section 1244 plan, assuming, arguendo, that there was such a plan and that such stock was issued, was not issued in exchange for stock taxpayer had acquired as consideration for these earlier advances, rather than for subsequent transfers of money or property. Stock acquired in exchange for other stock cannot qualify as Section 1244 stock (see Br., p. 21, infra.)

book speaks volumes as to whether these corporate records reflected his having received Section 1244 stock.^{10/}

There was, then, a total dearth of credible evidence supporting taxpayer's claim that he had invested over \$27,000 in Realty Transfer pursuant to a Section 1244 plan and that shares had been issued to him in conformity to that plan. The weakness of taxpayer's case is perhaps best borne out by his own tax returns. He first claimed that he had invested \$112,321.91 Realty Transfer in exchange for Section 1244 stock. He later reduced his claimed loss deduction with respect to Section 1244 stock to \$84,587.17. By the time of trial, taxpayer conceded that, at most, only \$27,782.96 of his investment had been made pursuant to a Section 1244 plan. This history, we submit, shows rather clearly that taxpayer never really advanced money to Realty Transfer with "an intention of realizing the benefits Congress had afforded" in Section 1244. Godart v. United States, supra, p. 637. Taxpayer's own vacillations more than bear out what the total dearth of credible, "substantially contemporary

^{10/} Taxpayer argues (Br. 10-12) that his failure to introduce the stock transfer book should not give rise to any inference as to the contents of that book. He argues that since, under Morgan v. Commissioner, 46 T.C. 879 (1966), shares of stock may be considered "issued" prior to the time they are physically delivered to the shareholder, the recordation of physical delivery in the stock transfer book should have no bearing on his claim for a deduction. This argument, we submit, ingores the essential basis of the Tax Court's determination--that taxpayer had failed to show that any stock was issued to him, either physically or in any other fashion, pursuant to a Section 1244 plan. Had the stock transfer book shown otherwise, that evidence would clearly have helped taxpayer's case. And, as the Tax Court held, the fact that taxpayer refused to introduce the stock transfer book, in turn, gives rise to the inference that the book did not show that Section 1244 stock had been physically issued to taxpayer.

objective evidence" as to a Section 1244 plan or the issuance of Section 1244 stock shows--that no plan was ever adopted and no stock ever issued with Section 1244 "in view." Godart v. United States, supra, p. 638. Section 1244 was clearly an afterthought, an attempt to sweeten a sour investment.

- C. In any event, taxpayer failed to establish that the purportedly issued stock was exchanged for consideration other than stock

Taxpayer argued below that various parties, including himself, initially developed the Florida property here as a joint venture. Taxpayer argued that, on June 4, 1962, he and these other parties decided to incorporate the project and contributed their interests in that joint venture to Realty Transfer ^{11/} on that date in exchange for Section 1244 stock. We submit, however, the record indicates the Florida project was never a joint venture. Rather, Realty Transfer purchased the property and made the improvements thereon with funds obtained from taxpayer, as indicated by his bookkeeping records, and from apparently other investors as well. (Exs. 0-I, 17-Q, 20-T, 23-W, 25-Y, 29-DD, 31-FF, 34-II, 48-WW, 49-XX, 61-AK.) The amounts taxpayer advanced to the corporation prior to June, 1962, constituted equity capital. See Gilbert v. Commissioner, 262 F. 2d 512 (C.A. 2, 1959).

11/ With respect thereto, taxpayer failed to submit evidence of the fair market values of this property alleged to have been exchanged for Section 1244 stock, as required by Section 1244 (d)(1)(A), which limits the amount of ordinary loss that may be recognized under Section 1244.

If taxpayer made his equity contribution, as his own records show, before the purported adoption of the Section 1244 plan, it would appear that if any stock was issued on June 4, 1962, it was issued not in exchange for money or property, as required by Section 1244(c)(1)(D), but for taxpayer's preexisting stock interests. Stock issued in return for such consideration cannot qualify for the benefits of Section 1244. Section 1.1244-1(f)(2), Example (i), Treasury Regulations on Income Tax (1954 Code). See Morgan v. Commissioner, supra. See generally, Hollenbeck v. Commissioner, 422 F. 2d 2 (C.A. 9, 1970).^{12/}

^{12/} A further ground supporting the decision of the Tax Court is that Realty Transfer was not "largely an operating company," as required by Section 1.1244(c)-1(g)(2), Treasury Regulations on Income Tax (1954 Code). Bates v. United States, 36 A.F.T.R. 2d 6074 (D.C. Ohio), vac'd, 37 A.F.T.R. 2d 1090 (1976).

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
FRANCIS J. GOULD,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

JULY, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 12th day of July, 1976, in an envelope, with postage prepaid, properly addressed to them as follows:

Herbert S. Tepper and
Stuart Malawer, Esquires
1 Old Country Road
Carle Place, New York 11514

Gilbert E. Andrews/eah
GILBERT E. ANDREWS,
Attorney.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 165. LOSSES.

* * *

(g) Worthless Securities.--

(1) General rule.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

* * *

SEC. 1244. LOSSES ON SMALL BUSINESS STOCK.

(a) General Rule.--In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as a loss from the sale or exchange of an asset which is not a capital asset.

(b) Maximum Amount for Any Taxable Year.--For any year the aggregate amount treated by the taxpayer by reason of this section as a loss from the sale or exchange of an asset which is not a capital asset shall not exceed--

(1) \$25,000, or

(2) \$50,000, in the case of a husband and wife filing a joint return for such year under section 6013.

(c) Section 1244 Stock Defined.--

(1) General.--For purposes of this section, the term "section 1244 stock" means common stock in a domestic corporation if--

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan,

(B) at the time such plan was adopted, such corporation was a small business corporation,

(C) at the time such plan was adopted, no portion of a prior offering was outstanding,

(D) such stock was issued by such corporation, pursuant to such plan, for money or other property (Other than stock and securities), and

(E) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock is sustained (or if such corporation has not been in existence for 5 taxable years ending before such date, during the period of its taxable years ending before such date, or if such corporation has not been in existence for one taxable year ending before such date, during the period such corporation has been in existence before such date), derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this subparagraph only to the extent of gains therefrom); except that this subparagraph shall not apply with respect to any corporation if, for the period referred to, the amount of the deductions allowed by this chapter (other than by sections 172, 242, 243, 244, and 245) exceed the amount of gross income.

Such term does not include stock if issued (pursuant to the plan referred to in subparagraph (A)) after a subsequent offering of stock has been made by the corporation.

(2) Small business corporation defi .--For purposes of this section, a corporation shall be treated as a small business corporation if at the time of the adoption of the plan--

(A) the sum of--

(i) the aggregate amount which may be offered under the plan, plus

(ii) the aggregate amount of money and other property (taken into account in an amount as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which was assumed by the corporation at such time) received by the corporation after June 30, 1958, for stock, as a contribution to capital, and as paid-in surplus,

does not exceed \$500,000; and

(B) the sum of--

(i) the aggregate amount which may be offered under the plan, plus

(ii) the equity capital of the corporation (determined on the date of the adoption of the plan),

does not exceed \$1,000,000.

For purposes of subparagraph (B), the equity capital of a corporation is the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders).

*

*

*

(e) Regulations.--The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.

APPENDIX B

T. C. Memo. 1975-351

UNITED STATES TAX COURT

IRVING MALAWER and RUTH MALAWER, Petitioners v.
COMMISSIONER OF INTERNAL, REVENUE, Respondent

Docket No. 6188-70.

Filed December 8, 1975.

Herbert S. Tepper, for the petitioners.

Peter W. Mettler, Jeffrey L. Davidson, Fred L. Baker,
and Stephen E. Young, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

QUEALY, Judge: The respondent determined a deficiency in petitioners' Federal income tax for taxable year 1964 in the amount of \$16,192.37.

The sole issue remaining for decision is whether petitioners' loss of \$27,732.26 on their investment of \$84,587.07 in Realty Transfer Corporation is an ordinary¹ loss under section 1244.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioners Irving and Ruth Malawer, husband and wife, resided in New York, New York, at the time their petition was filed. Petitioners filed a joint Federal income tax return with the District Director of Internal Revenue, Manhattan, New York, for calendar year 1964. They used the cash basis method of accounting. Ruth Malawer

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All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

is a petitioner solely by reason of having filed a joint return with her husband, Irving Malawer (hereinafter referred to as "petitioner").

Realty Transfer Corporation (hereinafter referred to as "Realty Transfer") was incorporated in Florida on August 7, 1957, for the purpose of purchasing real estate, constructing rental housing units thereon, and renting apartments to tenants. On November 16, 1959, Realty Transfer purchased real property in Winter Park, Florida. Petitioner presented evidence that during the period from November 16, 1959 through June 4, 1962, the property was surveyed and cleaned up, a building thereon was demolished, architectural plans were drawn and submitted, projections of anticipated income and expenses were prepared, funding for the project was secured, and brochures advertising the building for rental were prepared. A bank account was opened for the first time in 1962. No corporation income tax returns were filed for the years 1957 through 1961, inclusive.

Petitioner presented in evidence a single sheet of paper purporting to be a copy of the minutes of the first meeting of the board of directors of Realty Transfer held

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on June 4, 1962, purportedly signed by George Melter, now deceased. Petitioner was unable to produce the minute book of Realty Transfer at the trial. The copy of the purported minutes of June 4, 1962, listed the stockholders as George Melter, Jack Malawer, Irving Malawer, and Irving Weider, all of whom were stated to be present. According to the minutes, a plan was adopted whereby 50 shares of stock, each having a par value of \$5, would be issued over a period of not more than two years pursuant to section 1244 for an aggregate amount not to exceed \$500,000. Certificates were to be issued, for the consideration shown, as follows:

<u>Stockholders</u>	<u>Number of Shares</u>	<u>Amount</u>
Jack Malawer	9-5/8	\$ 27,782.97
Irving Malawer	9-5/8	27,782.96
George Melter	11-1/2	24,056.57
Irving Weider	19-1/4	89,544.86
Totals	<u>50</u>	<u>\$169,167.36</u>

Petitioner did not produce any evidence with regard to the issuance of the stock certificates referred to in the plan, although Realty Transfer's stock book was in his possession.

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Petitioner's accountant, Frank E. Knopf, testified that petitioner and his brother, Jack Malawer, conducted their affairs as a partnership, including the investment in Realty Transfer. He stated that accounts of both petitioner and Jack Malawer were kept in the name of Jack Malawer as part of a private business arrangement between them. Mr. Knopf kept ledger sheets of monies disbursed by Jack and Irving Malawer for investment in Realty Transfer. None of the entries indicate that money was disbursed for section 1244 stock.

On October 15, 1965, Realty Transfer filed U.S. corporation income tax returns for calendar years 1962, 1963, and 1964, using the cash basis method of accounting. In amended returns filed February 14, 1966, Realty Transfer reported losses as follows:

<u>Year</u>	<u>Loss</u>
1962	\$ -0-
1963	7,879.05
1964	425,118.92

The return for 1962 showed capital stock in the amount of \$169,167.36 at the end of the year. No stock was outstanding at the beginning of the year. The

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corporation had abandoned its Florida property by 1964, and the 1964 return showed no assets at the end of the taxable year. Realty Transfer was dissolved on June 30, 1967, for failure to pay its corporation capital stock tax to the State of Florida.

Petitioner filed his return for 1964 on October 15, 1965. Petitioner filed an amended return on March 17, 1966, in which he claimed a loss of \$84,587.07 on the stock of Realty Transfer, of which \$50,000 was claimed as an ordinary loss under section 1244(a), and the remaining \$34,587.07 was claimed as a capital loss in accordance with the limitation of section 1244(b). In his notice of deficiency, respondent disallowed as an ordinary loss the deduction of the \$50,000 which was claimed under section 1244(a). Petitioner conceded at trial that not more than \$27,732.96 of his claimed loss of \$50,000 was attributable to section 1244 stock.

OPINION

Petitioner made investments totaling \$84,587.07 in Realty Transfer, a Florida corporation. Realty Transfer purchased real estate in Winter Park, Florida in 1959 and

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during the period 1959 to 1962 engaged in activities relating to the development of the property as residential rental property. According to a copy of what purported to be the minutes of a meeting of the board of directors of Realty Transfer held on June 4, 1962, Realty Transfer adopted a plan to issue stock to the shareholders in accordance with section 1244. The amount of consideration to be given by petitioner for his shares was \$27,782.96, but no evidence was presented by petitioner that this amount was actually paid for such shares or that any stock was ever issued to petitioner. Realty Transfer became insolvent during 1964 and abandoned the property. Petitioner claims an ordinary loss on account of the worthless section 1244 stock in the amount of \$27,782.96.

Respondent challenges both the authenticity of the minutes and the adequacy of the evidence presented by petitioner with regard to the issuance of stock which would

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qualify under section 1244. Respondent contends that the

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SEC. 1244. LOSSES ON SMALL BUSINESS STOCK.

* * *

(c) Section 1244 Stock Defined.--

(1) In General.--For purposes of this section, the term "section 1244 stock" means a common stock in a domestic corporation if--

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan,

(B) at the time such plan was adopted, such corporation was a small business corporation,

(C) at the time such plan was adopted, no portion of a prior offering was outstanding,

(D) such stock was issued by such corporation, pursuant to such plan, for money or other property (other than stock and securities), and

(E) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock is sustained * * *, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities * * *; except that this subparagraph shall not apply with respect to any corporation if, for the period referred to, the amount of the deductions allowed by this chapter (other than by sections 172, 242, 243, 244, and 245) exceed the amount of gross income.

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petitioner has failed to establish that the corporation adopted a plan as required by section 1244(c)(1)(A) and, therefore, did not issue any stock pursuant to such plan as required by section 1244(c)(1)(D).

Petitioner contends that the copy of the purported minutes presented in evidence establishes the adoption of a plan for the issuance of section 1244 stock. Petitioner further contends that the corporation income tax return filed for 1962 establishes that stock was issued pursuant to the agreement because the capital stock outstanding as of December 31, 1962, exceeded the capital stock outstanding at the beginning of taxable year 1962 by the exact amount stated in the purported plan. If the purported minutes are read in conjunction with the 1962 return, petitioner claims that his payment of \$27,732.96 is established as having been paid for the shares to be issued pursuant to section 1244. Petitioner claims that the issuance of stock certificates is not necessary to constitute petitioner a shareholder, because stock certificates are merely secondary evidence of ownership. What is crucial, petitioner claims, is the payment of consideration therefor, and petitioner has established his investment in Realty Transfer, a fact which respondent does not challenge.

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Under section 1244(e), respondent is specifically authorized to issue regulations pertaining to records to be kept by a taxpayer and the corporation for which the taxpayer is claiming a loss on section 1244 stock as well as defining what constitutes the adoption of a plan under section 1244(c)(1)(A). Respondent has promulgated such regulations. The regulations clearly conform to the intent of the Congress.

Congress intended the 1244 provision to encourage investments in qualifying small businesses, see H. Rept. No. 2198, 85th Cong., 2d Sess., pp. 1-12. The courts have recognized that the Congressional purpose would be frustrated without contemporaneous proof that taxpayers seeking to qualify stock under section 1244 acted on that basis in making their initial investment decisions.

Rickey v. Commissioner, 502 F.2d 748 (9th Cir. 1974);

Anderson v. United States, 436 F.2d 356 (10th Cir. 1971);

Godart v. Commissioner, 425 F.2d 633 (2d Cir. 1970).

Necessary to such a showing is the adoption of a plan and the maintenance of adequate records showing the adoption of the plan and the issuance of stock pursuant to the plan.

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Section 1.1244(c)-1(c)(1), Income Tax Regs., requires that the stock be issued pursuant to a written plan which specifies the term of the plan and amount of consideration received for the issuance of stock. Section 1.1244(e)-1(a), Income Tax Regs., states that "[t]he plan to issue stock which qualifies under section 1244 must appear upon the records of the corporation." In order for its stock to qualify under section 1244, Realty Transfer must keep records showing, inter alia, the names of persons to whom stock was issued pursuant to the plan, the date of issuance to each, and a description of the consideration received from each; the certificates representing the stock which was issued pursuant to the plan; and, the equity capital of the corporation on the date of adoption of the plan. Among the records to be kept by petitioner (as a shareholder) are those showing the manner in which the section 1244 stock was acquired and the amount of consideration paid, such records to be maintained in a manner "sufficient to distinguish" section 1244 stock from other equity interests the taxpayer

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may have in the corporation. Section 1.1244(e)-1(b),
Income Tax Regs.³ See Wesley H. Morgan, 46 T.C. 878, 892
(1966).

Petitioner has failed to prove that Realty Transfer adopted a plan to issue stock pursuant to section 1244. Realty Transfer was incorporated in 1957. Petitioner acknowledged that meetings of the directors and/or shareholders of Realty Transfer had taken place on a number of occasions prior to June 4, 1962. Nevertheless, the purported minutes stated that the meeting held on June 4, 1962, was the first meeting of the board of directors. The production at the trial of purported minutes of only one meeting of the board of directors of Realty Transfer, which minutes are crucial to petitioner's case, is not sufficient

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H. Rept. No. 2198, 85th Cong., 2d Sess., p. 12,
takes note of the necessity for record-keeping regulations:

Regulations.--Subsection (e) of section * * * [1244] provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section. This would include authority to require the maintenance of records sufficient to establish the identity of stock that qualifies as section * * * [1244] stock.

to meet petitioner's burden. The conclusion is inescapable that the attempt to qualify the stock as section 1244 stock was an afterthought.

Petitioner has failed to provide the records required by section 1.1244(e)-1, Income Tax Regs., respecting the issuance of the alleged section 1244 stock. Neither the corporation nor the taxpayer record-keeping provisions have been met. The purported corporate minutes only state the amount of stock to be issued over a period of time for a stated consideration. Such minutes do not constitute proof that the stock was in fact issued. See Bernard Spiegel, 49 T.C. 527 (1968).

The fact that petitioner made equity investments in Realty Transfer in excess of the amounts contained in the purported section 1244 plan does not imply that such investments were made pursuant to the plan. On the contrary, petitioner's inability to distinguish among qualifying section 1244 investments and other equity investments is manifest in his failure to produce stock certificates, names, or dates for the issuance of section 1244 stock, or to correlate disbursements to Realty Transfer with the

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purchases of section 1244 stock. Petitioner concededly had the Realty Transfer stock books in his possession, yet he did not introduce them into evidence at trial. Thus, a presumption arises that the information contained therein would not support petitioner's claim to the deduction.

Albert L. Dougherty, 60 T.C. 917, 933 (1973); Peter E. Blum, 59 T.C. 436, 440 (1972); Estate of Dorothy E. Beck, 56 T.C. 297, 343-345 (1971); Wichita Terminal Elevator Co., 6 T.C. 1153, 1165 (1946), *affd.* 162 F.2d 513 (10th Cir. 1947).

In his individual income tax return for the taxable year 1964, filed on October 15, 1965, petitioner claimed a loss of \$112,321.91 on the sale of Realty Transfer stock, all of which was asserted to be section 1244 stock. On March 17, 1966, petitioner filed an amended return for 1964 in which he claimed \$84,587.07 as a loss on the sale of section 1244 stock. In both returns, the amount of ordinary loss claimed was limited to \$50,000, in accordance with section 1244(b). At trial, petitioner conceded that not more than \$27,782.96 of his \$84,587.07 loss was attributable to section 1244 stock. Petitioner's vacillations with respect to claimed deductions for section 1244 stock suggest that

petitioner had no contemporary knowledge of which equity investments, if any, constituted purported section 1244 purchases.

Petitioner has attempted to overcome his lack of proof with respect to the adoption of a plan and the issuance of stock pursuant thereto by resorting to the corporation income tax return of Realty Transfer for 1962, which reflected capital stock issued during the year in exact conformance with the purported minutes. But this return was prepared by petitioner's accountant and was not filed until October 15, 1965, the same day on which the petitioner filed his individual income tax return for 1964. This late filing of a self-serving document cannot be relied upon to establish the existence of a plan or the issuance of section 1244 stock during 1962.

Petitioner has the burden of proof. Rule 142(a), Tax Court Rules of Practice and Procedure. In the case of a special tax benefit, such as is provided by section 1244, the taxpayer must meet his burden of proof in each particular.

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See Childs v. Commissioner, 408 F.2d 531, 533 (3d Cir. 1969). Petitioner did not meet his burden with respect to the adoption of a plan to issue section 1244 stock or with respect to the issuance and payment for section 1244 stock.

We conclude that petitioner has not presented sufficient evidence to meet his burden of proof that Realty Transfer adopted a plan to issue section 1244 stock, in accordance with section 1244(c)(1)(A), or that Realty Transfer issued stock pursuant to such plan, as required by section 1244(c)(1)(D). Accordingly, any loss sustained by petitioner as a result of his investments in Realty Transfer must be deemed a capital loss.

Decision will be entered
for the respondent.